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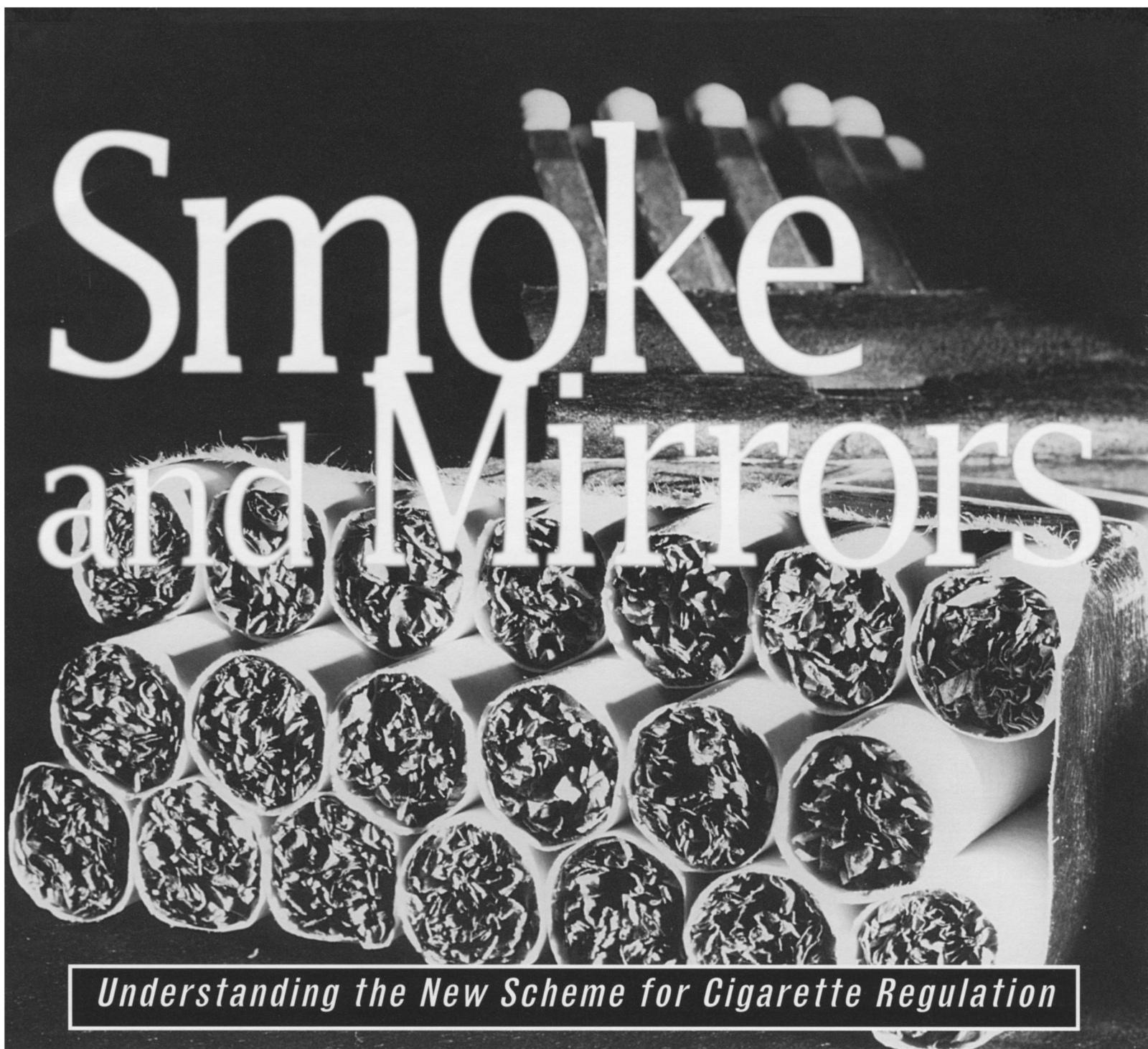
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Smoke and Mirrors

Understanding the New Scheme for Cigarette Regulation

Last June, U.S. cigarette companies, together with government officials, chiefly state attorneys general, drafted proposed federal legislation that would, if enacted, have a sweeping effect on the regulation of cigarettes, as well as on prospective cigarette industry liability.

Cigarette regulation is nothing new. Cigarettes have long been subject to heavy excise taxes at both the state and federal level, and Congress has mandated on-product warnings and written the warning language for cigarettes since 1964. Cigarettes have also been the target of decades of litigation, though here the cigarette industry has enjoyed an almost

BY W. KIP VISCUSI

unblemished record of success.

By 1997, however, the cigarette industry had been hit by a flurry of 40 state lawsuits seeking reimbursement for the health insurance costs associated with smoking. These suits, based on as yet untested legal theory, have led to multibillion dollar out-of-court settlements in Mississippi and Florida. They also prompted the legislative proposal, which would establish a reimbursement formula for all states. This article explores the nature of this proposed resolution, its implications for the cigarette industry, and its merits from the standpoint of social efficiency.



H. ARMSTRONG ROBERTS

THE PRICE TAG

Public understanding of the settlement may extend little beyond a single number—the widely publicized \$368.5 billion face value of the first 25 years of cigarette industry payments. The first payment, \$10 billion up front, would be followed by annual payments rising from \$8.5 billion the first year to \$15 billion in 5 years. The payments do not end after 25 years, but continue in perpetuity so that focusing only on the first 25 years understates the long-run implications of what is at stake.

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The timing of the payments is not inconsequential. Although payment amounts will be adjusted upward over time to reflect price increases (by 3 percent or the percentage increase in the consumer price index, whichever is greater), the settlement price tag of \$368.5 billion is not discounted to reflect its present value. If we were to discount the settlement payments using a 3 percent real rate of interest, the present value of the first 25 years of payments would be \$255.6 billion, with a present value in perpetuity of \$494.4 billion. Because of possible disagreements about the rate of discount, the focus has been on the total undiscounted package value.

The more important complication is that the value of the payments will vary proportionately with the unit sales volume of tobacco products. If cigarette consumption were to drop by one-fourth, the settlement payments would fall similarly.

Because of the sales volume linkage, the best way to think about the settlement is in terms of the cost per pack: the payment is equivalent to an additional 62¢ per pack tax. State and federal taxes already total 56¢ a pack for an annual total of more than \$13 billion. The new levy would bring the total tax per pack to \$1.18. Recently President Clinton voiced support for raising the additional tax to \$1.50 per pack, the same figure in Senator Edward Kennedy's legislative proposal.



cigarette prices would cause a 4–7 percent drop in smoking overall, it would cause smoking by teenagers to fall 12–14 percent. Thus the tax is particularly effective in discouraging youth smoking.

Another noteworthy distributional aspect of the taxes is that cigarette smokers tend to be poorer and more likely to be blue-collar workers than the average American. Indeed, cigarette taxes are regressive not only in terms of

the percentage of income going toward the tax, but also in absolute terms. Those in lower income groups pay more in terms of the total dollars of cigarettes taxes than the very affluent. If Congress passes this proposed resolution, the maintenance workers at the Capitol will pay more of the tax than the members of Congress who voted for the legislation. Such concerns may have led to the failure to enact a cigarette tax as part of the mid-1990s health insurance proposals.

THE ROLE OF TAXES

Taxes have a variety of functions, from raising money for the government, to penalizing behavior some may view as immoral, to helping align private and social incentives. If, for example, smokers impose net costs on others, taxes can discourage smoking, reducing it to the level that would be observed if smokers took full account of the consequences of their actions. Similarly, if smokers are making mistaken decisions that harm their future welfare, taxes can discourage these decisions just as would, for example, a more accurate understanding of the hazards of cigarettes.

Although the cost of the tax will be shared by consumers and firms (for firms will lose profits as sales drop), most of the cost of the tax will be borne by consumers. Tobacco industry payments could be structured differently—for example, as a lump sum tax on companies rather than as a per unit tax—so that costs would be borne solely by tobacco producers. But such a tax would do nothing to discourage smoking or align private and social incentives.

Antismoking critics of the proposed settlement want to have it both ways. They like per unit taxes because they discourage consumption and reduce societal smoking rates. But they want companies to bear all the tax, and they want payments to the government to remain the same even as sales decline.

The form the tax takes will affect whether it primarily decreases consumption or profitability. From the standpoint of social efficiency, it makes the most sense to link the tax to cigarette consumption if our intent is to make product purchasers recognize the social costs of their smoking decision.

The differential effects of the tax are of particular interest. Younger smokers tend to be more responsive to cigarette prices than older smokers are. Whereas a 10 percent jump in

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THE ROLE OF THE STATES

The 40 lawsuits filed against the cigarette industry represented an unprecedented attempt by state governments to recoup the insurance-related costs of a product. As the issue was framed by the states, the focus was a narrow one—the total increase in medical costs arising from cigarette smoking. Other human health effects and other welfare consequences of smoking were excluded.

Framed thus, what has been the cost to the states? The answer depends in large part on what one chooses to count. Table 1 summarizes my cost calculations for the two states that have settled out of court as well as for the two states for which litigation is most imminent. The medical care costs range from 1.7¢ per pack in Mississippi to 3.1¢ in Minnesota. Because smokers tend to be sicker than nonsmokers, their medical costs to the state, chiefly Medicaid, are higher. Focusing only on this cost indeed increases costs to the states, though

far less than claimed in the lawsuits.

More comprehensive cost tallies, however, give a different view. Consider the estimates for the state of Florida. Because of smokers' shorter life spans, they pay 1.6¢ per pack less in earnings taxes to the state than nonsmokers, but they also save the states 7.5¢ per pack in nursing home care costs and 5.2¢ per pack in pension costs. The total net savings is 7.9¢ per pack, so that Florida gains overall.

What would happen if in fact one concluded that cigarettes did impose a net insurance cost on the states? One could presumably recoup these costs through litigation, though at substantial additional cost. Another approach is simply to impose the tax at the time of purchase through an excise tax. Such excise taxes already exist, and they range from 18¢ per pack to 48¢ per pack for the four states in table 1. Thus, taking into account excise taxes, the states gain from 21.2¢ per pack to 56.6¢ per pack.

Even if one considers only the medical effects of smoking, however, nursing home expenditures should logically be included in these net calculations. And when they are, cigarettes on balance pay for themselves in terms of their medical insurance consequences for state governments.

WHY THE COST COUNTING DIFFERS

A dizzying array of figures has appeared in the press and in public debates over the costs of cigarette smoking. The primary reason for the wide range of numbers, of course, is the scope of what is included in the cost calculations. The states, as noted, use only the top row in table 1 in assessing their medical care expenditures.

But there are other reasons why such a seemingly straightforward economic exercise as calculating the costs associated with cigarettes could lead to so many different results. One springs from flaws in the way states calculate medical expenditures. First, states often estimate the medical care expenditures assuming that smokers live as long as nonsmokers—in effect charging smokers for their medical expenses after they are dead based on their relative

Table 1. Financial Effects of Cigarettes on the States (cents per pack)

	Mississippi	Florida	Texas	Minnesota
Net Financial Costs				
Medical care	1.7	2.6	2.4	3.1
Taxes on earnings	1.4	1.6	1.6	1.8
Nursing homes	-2.5	-7.5	-6.9	-7.8
Pensions	-4.3	-5.2	-3.2	-6.3
Total*	-3.2	-7.9	-5.6	-8.6
Costs Including Taxes				
Excise taxes	-18.0	-33.9	-41.0	-48.0
Net state costs	-21.2	-41.8	-46.6	-56.6

*Total includes other effects not itemized, such as sick leave and fires.

medical costs while alive. Second, state calculations often take no account of the fact that smokers have other demographic characteristics that lead to higher medical costs. Smokers, for example, are more likely to work in risky jobs and to be injured on them. Third, the estimates for the state medical costs generally exclude the share of costs that will be reimbursed by the federal government. Thus, the states are attempting to collect twice for this portion of the costs—once from the cigarette companies and a second time from Washington. The states argue that this reimbursement is a collateral source and should not be considered. The calculations reported above isolated only the portion of the costs borne by the states.

Finally, many of the widely varying cost estimates refer not to the states, but rather to the nation, including the federal government. The scale of these costs is much greater, but the general story line is the same.



Smokers have higher medical care costs of 58¢ per pack, with nursing home care savings of 23¢ per pack and pension savings of \$1.25 per pack. The total net insurance cost of smoking is a cost savings of 32¢ per pack—in addition to the excise taxes paid on cigarettes. The general spirit of this conclusion is consistent with other studies in the literature.

NONPRICE COMPONENTS OF THE PROPOSAL

Although the primary focus of the settlement has been on its impressive price tag, the agreement would also lead to sweeping nonprice regulatory measures. The Food and Drug Administration would take on broad authority to regulate cigarettes, and the marketing and advertising of cigarettes would change dramatically.

Cigarette packages would have a new series of nine rotating warnings, all bolder and stronger than those used now. Outdoor advertising of cigarettes would be banned, as would the use of cartoon characters, such as Joe Camel, and human figures, such as the Marlboro man, in advertising. Except in adults-only facilities and publications, cigarette companies would be restricted to black text advertising. The federal government would launch a \$500 million annual antismoking ad campaign, as well as a variety of other antismoking efforts, such as federal public smoking standards.

Both the nonprice regulatory provisions and the financial costs associated with the proposal will lower cigarette consumption. As sales decline, so too will the amounts paid by the tobacco industry as part of the settlement. Some have criticized the decrease in revenues without understanding that the lower revenues necessarily will accompany reduced consumption achieved through higher cigarette prices.

UNDERAGE SMOKERS

The proposed legislation includes a wide variety of measures targeted at reducing underage smoking. In addition to setting a minimum age of 18 to purchase tobacco products, it would require photo identification of anyone under age 27, ban the sale of tobacco products through vending machines, ban self-service displays of tobacco products except in adults-only facilities, license retail tobacco product sellers and require conformance with the terms of the license as a condition for holding it, impose penalties for violations, and decrease payments to states that do not meet the “no sales to minors” performance targets. Such stringent, carefully structured efforts are well suited to addressing a problem restricted to a segment of the smoking population.

The higher prices that will be charged for cigarettes will also, as noted, discourage consumption. Because the responsiveness of the demand for cigarettes by teenagers is roughly three times that of adults, the higher prices will probably lower their consumption much more than that of adults.

REGULATION The actual price increase may be twice the 62¢ per pack penalty levy because of the mark-up of cigarette prices at the wholesaler level—a mark-up, it should be noted, that harms cigarette producers, since it further depresses cigarette purchases.

The proposed legislation establishes a series of targets for reducing youth smoking: a 30 percent decline in underage use of cigarette products within 5 years, a 50 percent decline within 7 years, and a 60 percent decline within 10 years. If these targets are not met, additional “look-back” provisions would increase the penalties by up to \$2 billion per year.

Much of the impetus for the proposed \$1.50 per pack cigarette tax is that a 62¢ tax alone will not discourage consumption sufficiently to meet the stated targets. The estimates of the effect of the 62¢ tax, however, neglect the role of the nonprice measures as well as the mark-up that will occur on the taxes before they reach the retail level.

A more basic concern about using price as the principal policy lever for discouraging youth smoking is that most cigarettes are not purchased by underage smokers. Depending on the particular study, it appears that roughly 95–97 percent of all cigarettes are purchased by those over 18 years of age. Increasing prices for all consumers is thus a blunt policy instrument for discouraging youth smoking. It will impose substantial costs on people who are of legal smoking age and too often are relatively poor. Policies specifically targeted at reducing underage smoking can foster this policy objective more equitably.

WHAT TOBACCO FIRMS GET

Not all the provisions in the proposed legislation favor the states. Others, pertaining primarily to civil liability, are favorable to the financial health of the cigarette industry.

Most important, the legislation would end all present and future actions by state attorneys general. Cigarette companies would escape the potential liability they could face because of an unfavorable ruling about which costs count or because of an unpredictable jury.

The settlement would also preclude all future “addiction” or dependence claims, all class actions, and all claims for punitive damages. Individuals, however, could still sue for past conduct, so that in the long run the industry would not be free of the current set of liability concerns.

The value of these restrictions on liability is hard to assess. Certainly the tobacco company payments stipulated by the legislation greatly exceed any liability sum that would be estimated based on past success rates in litigation. But the stakes involved are enormous, with the outcomes being highly correlated. Losing one state suit, for example, greatly increases the likelihood of losing others. Addiction claims likewise could snowball if the cigarette industry developed a losing track record. The global settlement gives the industry a safe harbor from the vagaries of the tort system and the randomness of jury awards.

The proposed settlement would not provide for compensation of the plaintiffs' lawyers, but parallel agreements would lead to such payouts. Total fees to lawyers will be in the billions. Indeed, the private lawyers retained by Florida are seeking contingency fee payments of \$2.8 billion, or 25 percent of the total settlement, an amount that dwarfs their actual legal expenses, much of which were incurred after the national settlement was proposed, making compensation likely. In its initial review, the court rejected this legal fee claim, noting that "\$2.8 billion simply shocks the conscience of the court."

The role of the private attorneys in cigarette lawsuits has generally come under increased scrutiny. When, for example, a recent class-action lawsuit by flight attendants was settled out of court, the flight attendants received no financial compensation, but the trial lawyers received \$49 million—again, a sum far in excess of their legal expenses. Genuine concern is developing that the plaintiffs' lawyers in various tobacco suits should receive compensation for their legitimate expenses, but not windfall gains.

TOWARD A RATIONAL SMOKING POLICY

If a global settlement is ultimately approved by Congress, it will presumably be somewhere between the initial proposal and the \$1.50 per pack levy endorsed by the president and Senator Kennedy. Once these financial and liability issues are settled, the more important concern will be how society addresses smoking behavior.

Much of the disagreement to date stems from a confusion on the part of the antismoking forces over whether their goal is to harm the cigarette industry or to help consumers. The most sensible basis for policy is to foster rational and informed smoking decisions. As a practical matter, such an approach should lead policymakers to embrace rather than condemn technological improvements that enhance the safety of cigarettes. The smokeless cigarettes introduced by R.J. Reynolds—the Eclipse and the Premier—would have

In almost every other area of health and safety regulation, Washington has promoted and often required technological improvements to enhance safety. It can play a similarly supportive role for cigarettes by encouraging innovations to reduce health risks and expand consumer choice.

greatly diminished the cancer risk associated with smoking, yet leading public health officials attacked the new cigarettes as nicotine delivery devices rather than urging consumers to experiment with this clearly safer product. In much the same way, the recent development by Philip Morris of a smoking box that would trap side stream smoke and reduce environmental tobacco risks and exposures has been the object of ridicule.

In almost every other area of health and safety regulation, Washington has promoted and often required technological improvements to enhance safety. It can play a similarly supportive role for cigarettes by encouraging innovations to reduce health risks and expand consumer choice.

Critics contend that we may not know what innovations are safer or how much safety they provide. Often, indeed, there is real uncertainty: will filtered cigarettes raise or reduce the risk? More drastic innovations, however, such as the denicotined cigarette and the smokeless cigarette, should raise far less doubt as to their efficacy. And the existence of some uncertainty provides all the more reason for the government to take the lead in identifying the comparative product risks.

The government should establish a standardized rating system to assess the relative risks of cigarettes so that consumers can make informed choices. Providing information about tar and nicotine levels alone is not enough: it may not, for exam-

ple, capture carbon monoxide risks of smokeless cigarettes. The cigarette companies are in a difficult position

with respect to all such matters since they are not permitted to make health claims on behalf of their products. They can make only oblique claims, such as saying a cigarette is "smoother" or "light." Fostering safety innovations and providing the information that enables consumers to choose safer cigarettes remains a neglected component of the government's smoking policies.

A primary reason for such neglect is a governmental mind-set that is anti-industry. State and federal governments alike should abandon their combative stance, take a more open-minded approach to the safety of tobacco products, and make advancement of consumer welfare their paramount concern. ■

